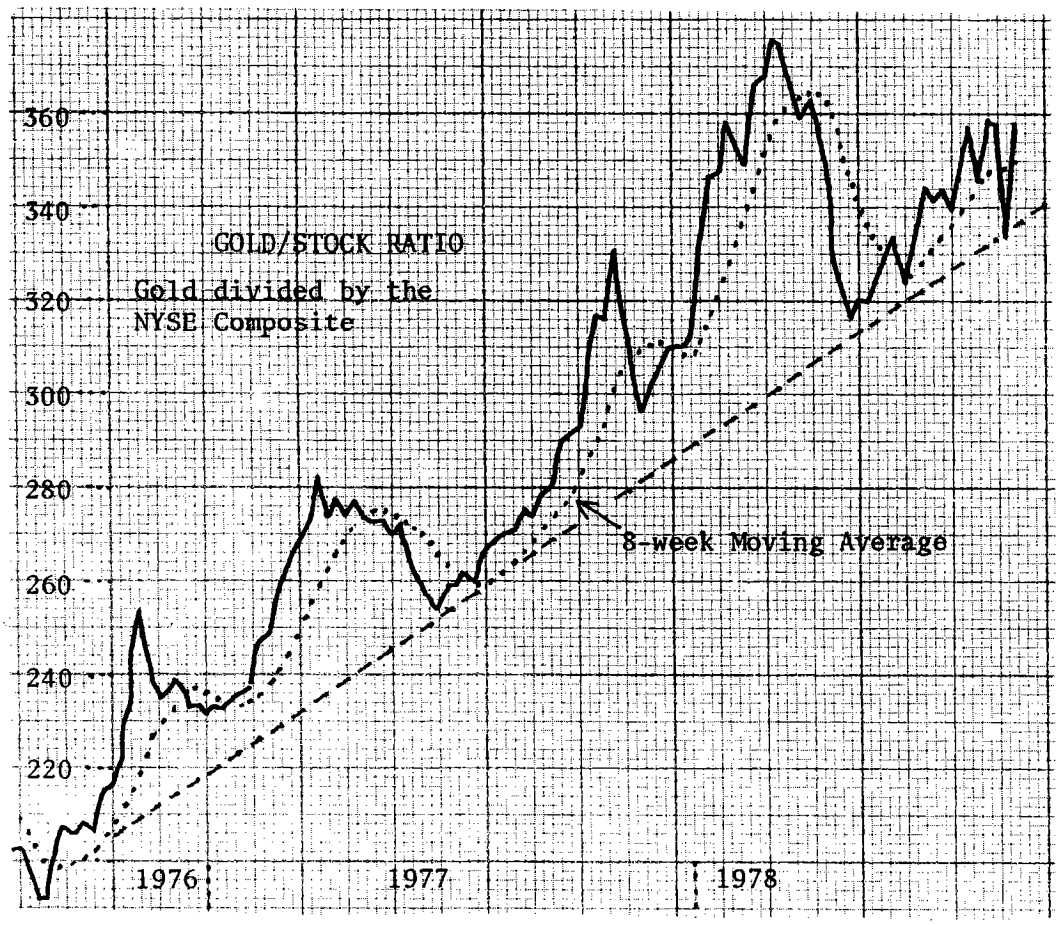
RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $150 Annually
Registered with the Securities and Exchange Commission

September 7, 1978 **LETTER 738**

Aug. 25, DJIA 895.53; PTI 924; A-D Ratio –15.66
Sept. 1, DJIA 879.33; PTI 937; A-D Ratio –16.03

BATTLE LINES: I have hesitated to feature this study, because its implications are as frightening as they are dramatic. But I think the time has come to put this study at the front of the Letter. Here we see the *ratio* of gold and the NYSE Composite stock average. Gold represents true money, wealth, timeless and immutable **value.** The NYSE Composite represents a very broad picture of "corporate America." The interplay of these two items, gold and the NYSE Composite, is of utmost importance in its implications.



I show here the weekly ratio (taken on Thursdays) together with an 8-week moving average of the weekly ratios. Anytime the ratio is rising it means that gold is outperforming the NYSE Composite and anytime the ratio is falling we know that the Composite is outperforming gold. As we study the action on the chart, one fact is patently clear. Since late-1976 gold has outperformed stocks. I have drawn a trendline through the lows of the 8-week moving average, and it is clear that the long-term trend of the ratios is up. Thus, gold is in a very strong relative strength trend in relation to stocks.

Let's put it another way. As long as the ratios hold above their long-term rising trendline, the markets are saying that one should be in gold rather than stocks. If the 8-week moving average breaks below its two-year rising trendline the market will then be saying that one should be in stocks rather than gold. It is as simple and unequivocal as that.

One interesting facet of this study is that you can extrapolate- or look ahead. For instance, note that we had three minor corrections (downward) in the ratios since 1976. Then we had a larger correction in the ratios during 1978. **What happens from here**, after the correction, is most important. If the ratio turns down and breaks the trendline it would appear that US corporations have a new lease on life, that something healthful is occurring and that stocks are finally outperforming gold. But if gold rises to say 220 and the NYSE Composite drops to say below 58.00, then the weekly ratio will climb into the 380 area. That would represent a major breakout to new highs for the ratio, following the 1978 correction. If that occurs, then the market will be saying, "Watch out!" It will be saying that investors are moving even further into real money and away from paper; corporate paper, dollar paper, Government paper, any kind of paper. The fact is that this chart is telling us that "Gold is winning!" Ultimately, gold always does win. But strangely, very few people understand that–yet.

THE PICTURE: Month after month passed, and each month brought new lows for the battered US dollar. Finally, the whistle was blown by the overseas creditors of the US. In effect, they said, "Defend your dollar, take the necessary steps, or we will stop 'rolling over' your short term debt!"

In the face of this emergency, the Administration has announced a "series" of actions (actually manipulations) which are calculated to stall the dollar's decline (at least, until after the November elections).

Again under pressure from foreign creditors (who want to turn in additional dollars for gold on the open market), monthly sales of US gold have been increased from 300,000 to 750,000 ounces. Thus, the US is selling its real monetary assets (and reserves) to protect its paper liabilities. This, of course, is a form of financial insanity. Next the US bank discount rate was reluctantly raised to 7.75% (to make the holding of dollars more attractive). Fed

funds were pushed up to the 8.25% level. Finally, overseas bank reserve requirements were cut to zero.

Not one of these measures deals with the fundamentals. The fundamentals are that the US Government is spending far more than it is taking in on the domestic front. And the US is buying more than it is selling on the international front. On August 29 the nation received a stark reminder of these fundamentals when it was announced that the US suffered a $3 billion adverse trade balance in July. This was the fourth worst trade balance in history.

But the trouble is coming from still another area. The great tide of compounding debt is closing like a giant vice around the US economy. In the next five months, the Treasury must raise over $30 billion in new money. This amounts to almost $7 billion a month on average, a staggering figure. With state surplusses dwindling, with banks competing via their new "six month certificates," with foreigners wary of the dollar and additional dollar debts, the new money will have to come largely from the American public. Therefore, it is entirely possible that short-term interest rates will soar before 1978 is out.

THE MARKET: In the face of what would seem to be perpetual inflation, the US markets have turned to "speculation." And most of it has been on the AMEX. But the NYSE has its own speculative favorites and the word is, "gamble on the gambling stocks." Some of these issues have gone up as much in a day as they will earn in the next one to three years. From the looks of it, many buyers must believe that gambling is fated to nudge out autos as the leading industry in the nation.

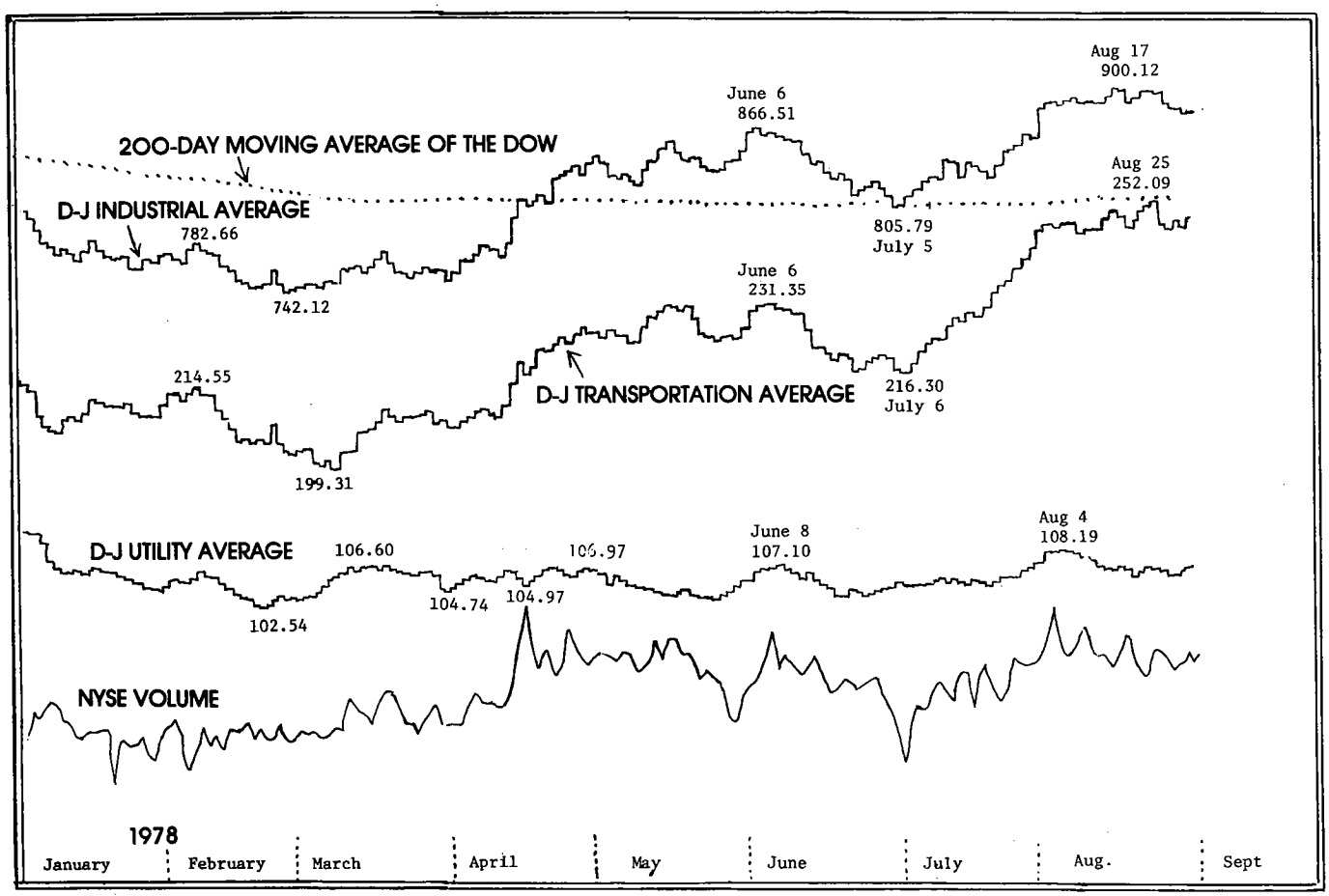
The profile of the D-J Averages, in comparison, appears embarrassingly stodgy. As you can see on the page 2 chart, the Industrials have been forming a "line." The range of the Dow price within the line has been an extraordinarily narrow 2.2% over the past four weeks. The same is true of the Transport and Utility Averages although the latter has had a slight downward bias.

Classically, this type of line in the Averages represents an area of opposing forces, a zone in which the buying and selling are very much in equilibrium. There's little use in trying to outguess the Averages when they are in a line formation. A **joint** breaking of the line either up or down will usually point the direction of the market for some time to come. I am particularly interested in the Industrials here because they have been holding just over the 878.45 level. That level represents the 50% or halfway level of the entire 1976-78 decline in the Dow, and I have stated that the Dow's essential strength or weakness may be gauged by its ability to hold above the 878.45 level.

The Dow crossed above the 878.45 level on August 2 and it has held tenuously above that level ever since–never very far above 878.45, but nevertheless above it. It will be most significant to see whether the 878.45 level holds–or gives way.

DOW DIVERGENCE: In the last Letter I included a long-term chart of the D-J Industrial and Transportation Averages. And I drew particular attention to the two-year string of divergences in these two Averages. Those divergences are still in force. And the Industrial Average is showing a fair degree of weakness.

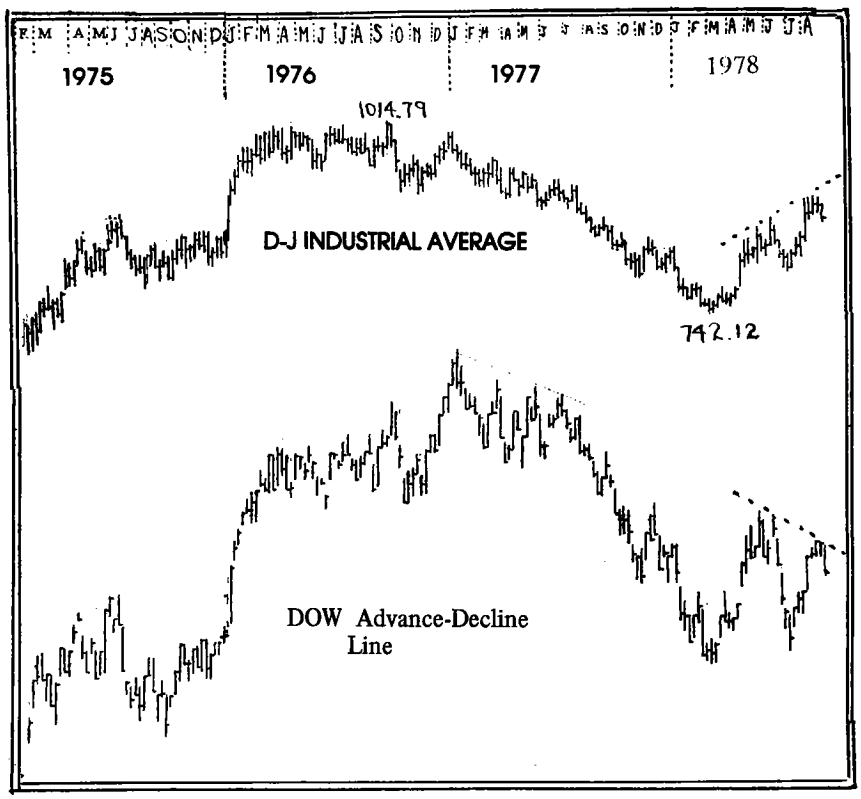
There is another divergence developing, and I want to show it. It's one that very few analysts or investors are aware of. For many years I have kept an advance-decline index of just the 30 Dow Industrial issues. Each day I compute the plurality of advances or declines for the 30 Industrials. Over the years I have



seen many minor divergences, but I have never seen a divergence as striking as the one that now exists.

The accompanying chart is not a daily, it is a weekly chart of the Dow and its own A-D line. Here we see the recent 1978 Dow advance to the June high of 866.51. A decline ensued, followed by a new advance which took the Dow to 900.12 on August 17. But on the latest advance the Dow A-D failed very dramatically to confirm, as you can see on the chart.

The obvious meaning of the divergence is that fewer and fewer of the Dow Industrials issues were participating in the last advance to the 900.12 peak. As I said, I've seen minor divergences in the Dow but never anything this flagrant. I can only conclude that the Dow has probably topped out. I would be surprised to see the Dow (in view of this non-confirmation) push decisively above 900.12 again.



SUPER CYCLES: (Chart, page 4). A greal deal of confusion exists regarding where we are in the market. Some analysts believe we are in a new bull market that started from the 1974 lows. Others are of the opinion that a new bull market began at the February 28, 1978 low. Still others think that we are in a bear market correction of the 1976-77 decline.

I've pondered the whole picture for many months, and this is my conclusion. (My conclusion is based on the very long-term picture of stock trends in the US): A super-cycle bull market began in July, 1932. That super-cycle bull market developed in three distinct and major bull segments. The first segment was the bull market of 1932-37. The second was the bull market of 1942-46. The third segment was the huge 17-year bull market of 1949 to 1966.

I've altered or rearranged my thinking somewhat as to what has happened since 1966. I believe my latest conclusions are crucial for us in our investment approach. This is how I view the action since 1966. I believe we are now in the midst of a classic super-cycle bear market. The bear market will ultimately correct the entire rise from 1932 to 1966. Furthermore, I believe the bear market has already moved through two of its three phases.

The first phase of the bear market occurred during 1966 to 1970 (see accompanying chart courtesy of *Horsey*, Salisbury, MD 21801). The first phase succeeded in erasing some of the "foam and froth" of the 1965-66 bull market top. Yet there was a general atmosphere of disbelief (in the bear) during 1966 to 1970, and this is as it should be during the initial phase of a major bear market.

The second phase of the bear market started from the January, 1973 high and carried to the December, 1974 low of 577.60. During the second phase the nation began to perceive some of the severe problems which the country is facing, problems such as illiquidity, chronic inflation, declining productivity, and a punitive tax system. The 1973-74 stock smash was the worst decline since the 1930's. Almost every stock on every exchange suffered during this second phase descent. And by 1974 investors were well aware that the American economy was in severe trouble. The decline in the dollar and the rise in gold told even the most stubborn optimist that something was wrong.

Following the end of the second phase, we moved into a major bear market (upward) correction. I now view all the action in the stock market since late-1974 as a post-second phase bear market correction. Traditionally, as I have written many times before, the correction following the second phase of a bull (or a bear) market is the deceptive one, the one that fools almost everyone. In my opinion, when the current second phase is over, we will then go into the third and final phase of the bear market. The third phase should see some of the grimmest and most vicious stock market action yet seen in this entire bear market. It should take the Dow and most stocks on the various exchanges to new lows. In this third and final phase, we will see distress selling for the first time as people and institutions sell stocks for no other reason than to raise money. It will be during the coming third phase that the "blue chip" and "growth stocks" will undergo their most drastic declines. As I see it, the factors which will wring out and depress stocks during the third or final phase will be (1) massive dividend cuts, (2) bank failures, (3) monetary chaos and a collapse of the dollar, and (4) credit liquidation on an unprecedented scale.

A few months ago I quoted the famous Dow Theorist, E. George Schaefer on the bear market and on gold. Schaefer possessed an amazing intuition about the markets, although he was constantly revising and updating his opinions. Schaefer believed that the bear market (which began in 1966) would end with gold sky-rocketing and with the Dow at a very low level, perhaps at 200 to 300.

In one of his last letters (August 24, 1974) Schaefer wrote ". . . *but the general market could still move lower into an area below its Dow 631.16 close of May 26, 1970 before our next rally occurs. If so, then (somewhere below the 631.16 low) I would be inclined to say that we probably have seen the end of the second phase of this primary bear market.*" And he added, "*At some*

point this selling will come to a temporary climax, and distorted as this second phase down has been with its two synthetic rises of 1968 and again in 1972 (both Presidential election years) it seems to me that it should end at some point below Dow 631.16 before the third and final phase down develops on low volume."

Tragically, Schaefer died in September, 1974. Therefore, he did not get a chance to witness the market action when (a month later) the Dow broke below the 631.16 level. What happened next was that the Dow slid another 54 points to 577.60. There the 1973-74 decline abruptly ended.

I've long pondered what E. George Schaefer would have said at the final 1974 low. My considered opinion is that Schaefer would have said at that point the second phase of the bear market had ended–and that the third and final phase lay somewhere ahead.

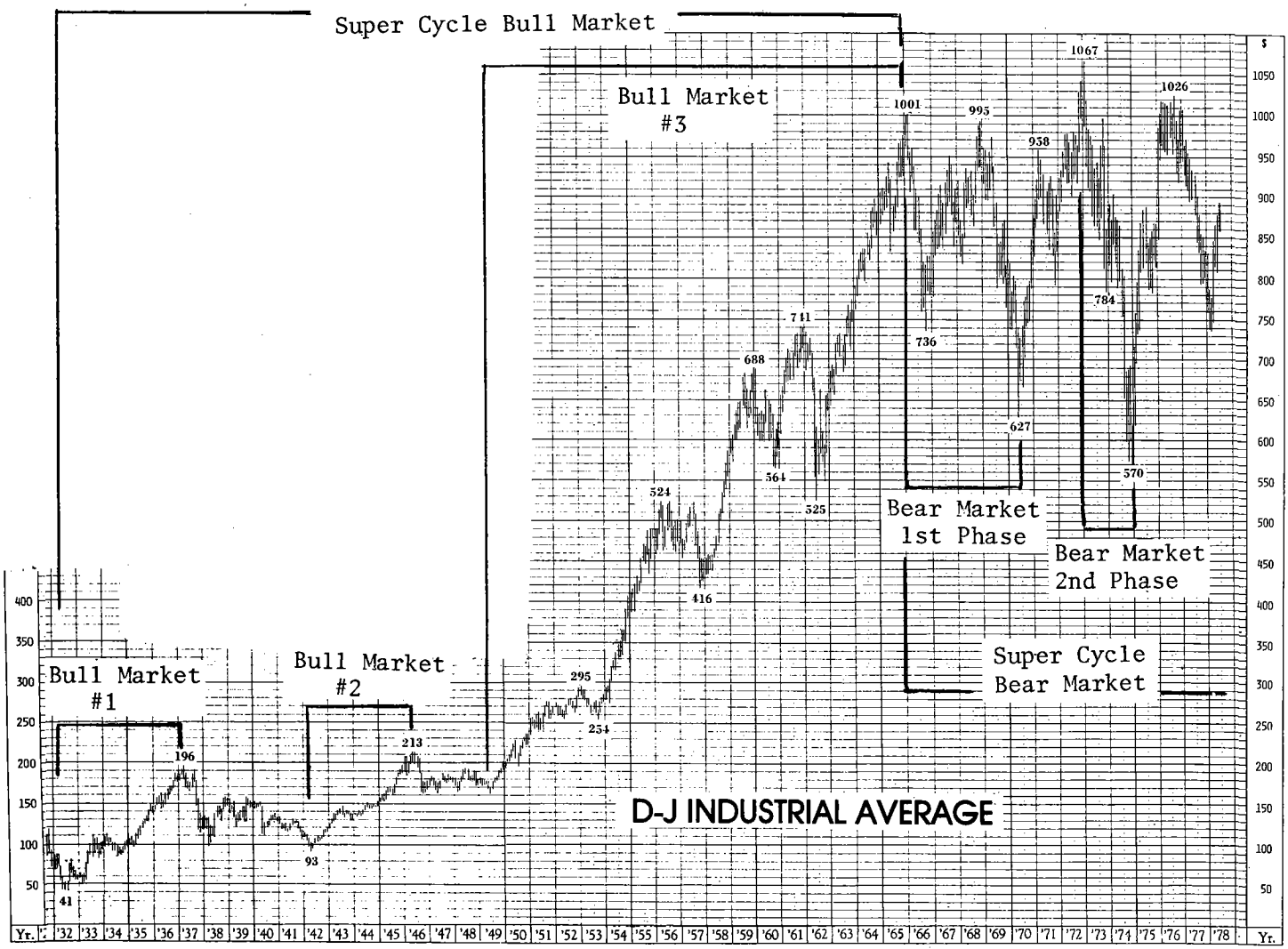
But the third phase of the bear market was not fated to develop at that time. Instead, in the face of coming tremendous infusions of bank credit, the market turned up and entered into a corrective phase. This was the deceptive rise that was to separate the second phase of the bear market from the third or final phase.

Two things bothered me at the December, 1974 lows (and I was bullish on the market at the time). The first was that the Dow itself had not collapsed, and I knew that the third phase of a bear market almost always sees a massive collapse in the "big name" stocks. In the face of a crash in most of the stocks on the various exchanges, the Dow nevertheless retained roughly half of its peak value.

The second thing that bothered me was that we never saw any credit liquidation. True, we had seen a big reduction of margins in the stock market and we had seen terrible declines in stocks themselves. But nowhere else in the economy did we witness liquidation of debt, a "squeezing out of the water." Yet primary bear markets exist for the purpose of **correcting the excesses** of the preceding bull market. The economic excesses were simply never corrected during 1966 to 1974. As a matter of fact, the excesses became even worse after 1974. Instead of allowing the natural corrective forces to take hold, the Government fought the corrective pressures with the result that by 1975-76 the country was generating even more debt, and there were more excesses built into the basic economy of the nation than ever before. The patient was never allowed to rest and recover. He was just given a bigger shot of narcotics.

I've been writing about the ominous debt situation in almost every report. Yet the full pressure of the debt has not yet exerted its bearish force on the economy. My belief is that this is what is going to happen during the coming third phase of the bear market. And the longer the Government succeeds in holding off the third phase, the more drastic will be its repercussions.

Question: Russell, if you're right, what can we expect and what can we do to protect ourselves?



Answer: I'm preparing a forthcoming Letter which I believe will provide an outstanding perspective on the coming major crisis in debt. But in my opinion, we are most definitely moving toward the point where the US will not be able to service the skyrocketing US total debt (debt which will pass $800 billion in 1979). Forget paying off the debt or even making a dent in the debt. No one expects that ever to happen. But what I'm talking about is the *inability to even service the debt!* As we grow closer to a "no servicing" crisis, we will see the Fed buying more and more of the US debt issues. This process is highly inflationary. It will, in my opinion, lead inevitably to wage and price controls, controls on corporate profits (Miller has already put out a "feeler' on that one) and also controls on the flow of foreign currencies.

Question: If that's true, where does an investor go?

Answer: I think we will have to go more and more into gold. I do not trust holdings of foreign currencies such as Swiss francs and German marks. What I mean is that barriers will be erected against US dollars going into those currencies. The barriers could come from the US or the foreign nations–or both.

Question: Do you think the Government would try to confiscate gold?

Answer: I doubt it. In 1933 when gold holding was made illegal, the price of gold was boosted in an effort to re-flate the depressed US economy. But the gold rise since 1970 has been for an entirely different reason. Held down in price for 40 years by Government edict, gold has advanced since 1970 as it adjusted to four decades of inflation and a steady decline in paper currencies. Thus, natural forces have moved gold up since 1970, whereas the price of gold was mandated upwards in 1934. People in 1934 were not particularly disturbed by the gold ban. They gave up their gold for dollars in the '30's because the dollar was "as good as gold." Nobody questionned the dollar then; they questionned their ability to get their hands on dollars! Today, everyone questions the dollar, and I seriously doubt that many people would give up their gold for the Government or anyone else. The Government knows this.

Furthermore, today many wealthy and influential individuals hold gold. These people have great power in Washington. I don't think they would easily give up their gold. In other words, gold is in strong hands today. Strong hands tend to have a powerful influence on the Congress and the President. Therefore, I do not see gold confiscation in the US at any time ahead.

Question: Russell, when do you see the current second phase upward move in the market ending?

Answer: My guess would be before 1978 is out, but no later than the first quarter of 1979. Next year (1979) will be the fifth year since the 1974 major bottom. No market since World War II has extended five years from a major bottom before (the intervals have never been more than four years). Therefore, as I see it time is running out for this market rise. When the market and the Averages turn down, I would guess that the third phase decline of the bear market (which began in 1966) would be beginning.

When the market and the Averages finally turn down in earnest, I would guess that we would be witnessing the start of the third phase of the bear market which began in 1966.

Question: Won't the Government fight any third phase downturn?

Answer: You bet they will! They'll fight it tooth and nail. When it becomes clear to the Government that a recession is on, they will embark on a tremendous monetization of the debt along with all kinds of tax cuts and spending programs. Such action will be disastrous for the dollar, so we can also expect to see every kind of currency manipulation. Yet, manipulations aren't going to do it–only balanced budgets would save the dollar. But at the point of recession, balanced budgets would mean economic collapse. So forget balanced budgets, they're Administration pipe dreams.

As I see it, the fundamentals are coming ever-closer to expressing themselves. A further decline in the dollar would frighten Wall Street and terrorize our foreign creditors. But the dollar is doomed to fall in the face of the impending US inability to service its debt. That phenomenon, together with the out-of-control US deficits, will exert an increasingly bearish pressure on stocks.

GOLD SITUATION: On August 16 gold recorded an historic high (London afternoon) fix of 215.75. A sharp reaction carried through to the end of August. On August 29 the second fix was 199.70. This temporary breaking of the 200 psychological barrier was brought on by the news of the US boosting its gold auction totals. But the break below 200 lasted only a day, and by September 1, gold was over 208.

I consider the gold action in the face of the latest US attack to be good, and more and more I feel that gold will resist Government onslaughts. Actually, as noted in the latest *Bank Credit Analyst*, the "*. . . sales of 3 million (additional) ounces, equal to $600 million at $200 an ounce from November to February, will cover only about six days of trade deficit at the rate it was chalked up in July. Hence it can only be interpreted as another gambit in the psychological war against gold, in keeping with the Administration's view that the dollar problem is psychological rather than real. It is somewhat suggestive of the third generation spendthrift selling of the family silver to pay interest at the bank.*"

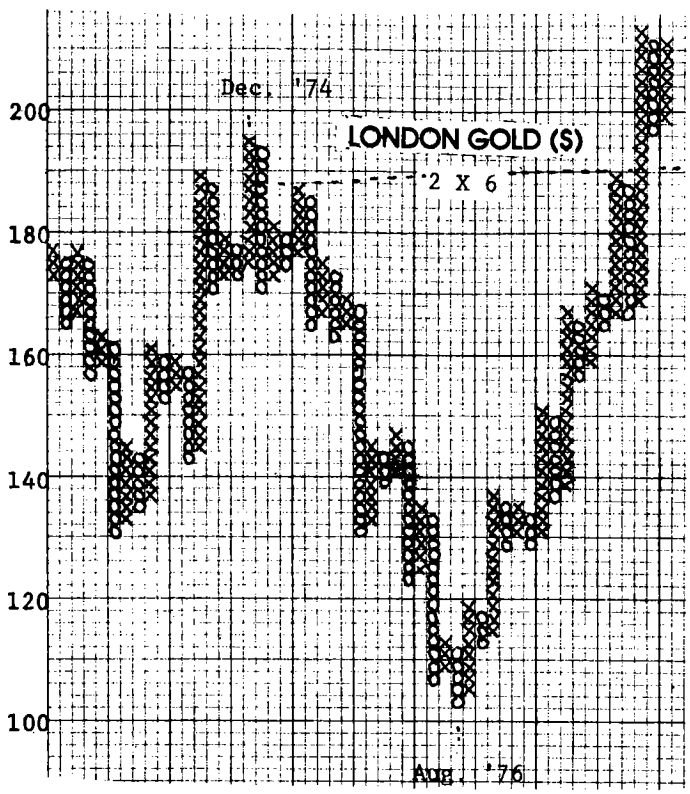
The daily chart at the bottom of page 6 shows gold and three moving averages (MA's) that I keep. The shorter 4-week MA now stands at 207, and gold in mid-August broke temporarily below this. The 13-week MA now stands at 195. The much longer 50-week MA is at 177. All three MA's are rising now, and I would consider it good action if gold continues to hold above 200, superb action if gold holds above its 4-week MA at 207.

I also show (page 6) my point & figure chart for gold. Each box on this chart equals 2 points and only rallies or declines of 6 points or more are shown. Thus this graph provides a very concentrated but interesting picture of gold. On a vertical count based on the recent rally from 168 to 214 on the chart, I get a projected "target" of 306 for gold. On a horizontal count, based on the fact that the bottom formation in gold is 28 boxes across, I get an upside count or projection of 272 for gold. (On my 1 X 3 point & figure chart of gold I get an upside target, based on a horizontal count, of 308). Thus, the basic structure of the gold price movement indicates that gold could run **considerably higher**–in due time.

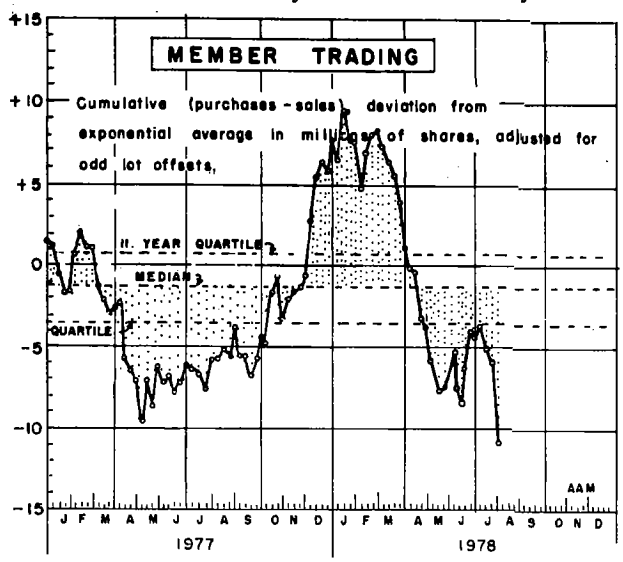
A few comments: On a seasonal basis, since 1963 gold and gold shares have almost always been a good buy during *a fourth quarter dip* or fourth quarter low. The current gold strength is contra-seasonal–which is bullish. Gold momentum (13-week rate of change) is now 112. In 1974 gold topped out with momentum at almost 180. This suggests that gold is hardly over-bought in this area. Also, on September 1, my gold stock average recorded a new high of 33.62 (see chart on page 6 of the last Letter). To confirm, London gold will have to hit 216. If gold touches 216, gold will probably head for the 225-230 area, and if so, we'll take it from there in forthcoming Letters.

HOW TO: Gold can be easily owned via gold coins such as Krugerrands or Coronas. These can be purchased from reputable dealers or through certain banks (many ads now appear in the *Wall Street Journal* and *Barron's*). Gold coins can be stored in your bank vault. I am not one of those who favors storing gold in Swiss banks (if it's ever again illegal to hold gold, it will be just as illegal in a Swiss bank). Gold can be purchased in bullion form through major stock brokerage firms, but you should **not** take physical possession of bullion since it may have to be assayed before you sell it.

Note: the longer gold holds "over 200," the more the public is going to become used to the idea of "200 dollar gold." This process will be bullish, since I believe that the public will be stepping up its gold coin purchases dramatically once the new over-200 price for gold is *accepted*. It's ironic: the public fully accepts inflation and Government deficits, yet they are still basically afraid of gold (how many people do you know who own any large amounts of gold?).



LATE MARKET NOTES: Both the A-D ratio and my Primary Trend Index have been edging up to new highs, but the Dow is stubbornly refusing to confirm. Speculation in a limited number of stocks has been nothing short of frenzied, and I like this market less and less. My ratio of Aaa bond yields to T-bill



yields just dropped below 1.20, and this is bearish for equities. It means that pressure is now hitting the money markets. Exchange members have been selling on balance all year, and recently their selling has amounted to a torrent (see chart, courtesy of *Technical Trends*, Box 228, Chappaqua, NY 10514). The members usually have inside statistics on the market, and it is generally not wise to go against them, once they move out on a trend basis. Consequently, I would now move out of ALL stocks, even those trading issues that I recently recommended. I would have only two positions now–gold and T-bills.

As for bonds, despite the recent rally I believe the bond market is in for major downside pressures in the period ahead. Temporarily, the down-forces are hitting the short end of the debt markets with the long end holding. But a persistent rise in T-bills is going to hit the long-term bonds–therefore, stay with bills for the time being.

THE NEXT LETTER will be one day later than usual due to my speaking engagement in San Francisco on the weekend of September 15. NEXT MAILING WILL BE SEPT. 21.